Euro wrap-up

Overview

- While revised euro area GDP data reported a contraction in Q1, Bunds followed USTs lower.
- Gilts ended the day little changed, while a UK survey suggested that business inflation and wage expectations remain relatively well behaved.
- On Thursday, the ECB will hike its key interest rates by 25bps and leave further tightening on the cards as it revises it inflation projections higher. April data for German industrial production, factory orders and goods trade, and UK GDP are also scheduled.

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Daily bond market movements

Bond	Yield	Change
BKO 2½ 06/28	2.685	+0.030
OBL 2½ 04/31	2.764	+0.028
DBR 2.9 02/36	3.034	+0.015
UKT 4⅜ 03/28	4.327	-0.002
UKT 4⅛ 03/31	4.456	+0.006
UKT 4¾ 10/35	4.895	-0.002

*Change from close as at 4:30pm BST.
Source: Bloomberg

Euro area

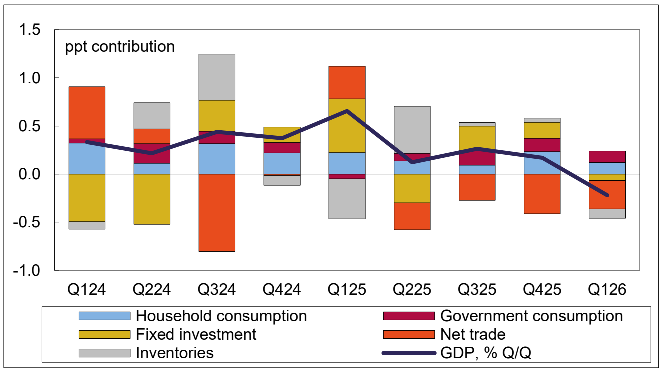
Revised euro area GDP data points to contraction in Q1 due to record decline in Irish output

After we flagged the risk yesterday, today's updated GDP data brought a non-negligible downwards revision to euro area GDP growth in Q1. Contrasting the modest expansion initially reported (+0.1%Q/Q), economic activity is now estimated to have contracted for the first time in four years (-0.2%Q/Q), the sharpest drop since the first pandemic lockdowns. This left output up just 0.3%Y/Y in Q1, down almost a percentage point from Q4, the softest pace in nine quarters and well below the euro area's potential growth rate. But today's revision was entirely due to the impact of yesterday's rogue figures from Ireland, where the record quarterly decline in GDP (-12.1%Q/Q) related entirely to the activity of multinationals based there for tax reasons knocked almost ½ppt off euro area growth. Indeed, except France and Portugal, today's release confirmed expansion across the larger member states, with accelerated growth in Germany and solid expansion in Italy (both 0.3%Q/Q) and ongoing outperformance in Spain (0.6%Q/Q). When excluding Ireland, euro area GDP rose 0.3%Q/Q, just 0.1ppt softer than in Q425 and bang in line with the ECB's March macroeconomic projection.

Final domestic demand maintained uptrend but employee compensation growth moderated further

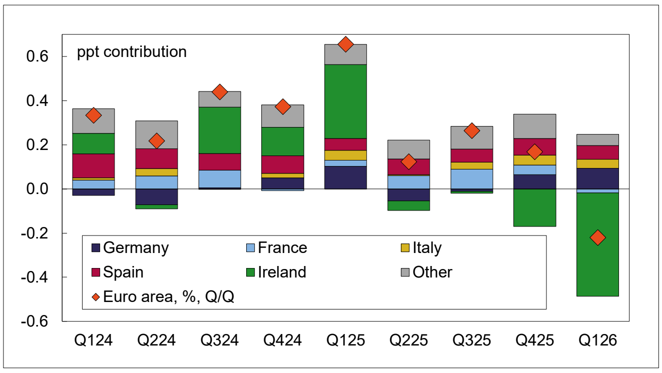
Unsurprisingly, the Irish distortion had a meaningful impact on the euro area expenditure breakdown too. Today's release reported the steepest decline in goods exports in 2½ years (-1.3%Q/Q), which more than offset a rebound in services exports (1.9%Q/Q). Compounded by a third consecutive increase in imports, net trade subtracted 0.3ppt from GDP growth. But when excluding Ireland, net trade would likely have made a positive contribution to GDP growth in Q1 for the first quarter in four. Meanwhile, inventories also subtracted from growth for the first quarter in a year. In contrast, final domestic demand continued to expand at the start of the year. Household consumption growth slowed but was positive for a tenth successive quarter (0.2%Q/Q), while government consumption (0.5%Q/Q) maintained a steady uptrend. Admittedly, fixed investment fell slightly in Q1 (-0.3%Q/Q) following upwardly revised growth in Q4, with declines in construction and transport equipment more than offsetting a rebound in expenditure on intellectual property. And a first year-on-year a decline in firms' unit profits in five quarters might pose further downside risks to near-term capex plans. Indeed, given the shock to energy prices, we would expect unit profit growth to remain in negative territory this year as firms struggle to pass on increased costs to customers. But while unit labour cost growth picked up, Governing Council members might take comfort from the further moderation in growth of employee compensation in Q1 to a near-five-year low of 3.4%Y/Y, a touch below the ECB's expectations, and so far softer at the onset of the war in the Middle East than ahead of the previous energy shock after Russia's invasion of Ukraine in 2022.

Euro area: GDP growth & expenditure contributions



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Country contributions to GDP growth



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

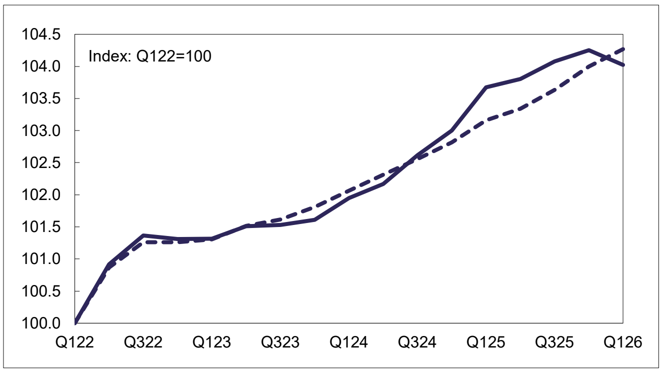
ECB set to raise rates on Thursday for first time in almost 3 years

Today's negative euro area GDP print will have no impact whatsoever on the ECB's decision-making at its policy meeting in the coming week. President Lagarde looks bound to announce a 25bps hike on Thursday to take the deposit rate to 2.25%. And while she will continue to insist that future decisions will be taken on a data-dependent and meeting-by-meeting basis and that the outlook for policy will depend in no small part on events at the Strait of Hormuz, she will likely make clear, either explicitly or implicitly, a hawkish bias. Certainly, at the previous meeting at end-April when policy was left unchanged, Lagarde's tone had already become more hawkish, flagging the intensified upside risks to inflation, which appeared of much greater concern to the policymakers than the increased downside risks to economic activity. The account of that meeting subsequently reported that "a number of" Governing Council members already "would not have opposed raising rates". Since then, with no restoration of normality at the Strait of Hormuz, crude oil prices have remained above the path assumed in the ECB's projections, which were hastily produced ahead of the March meeting just after the outbreak of conflict. Admittedly, pressures on prices of natural gas, which are of greater importance to European power generation, are not more intense. And energy inflation has also been restrained by temporary government support measures in certain member states. But, overall, the price shock from the Middle East appears more persistent than originally assumed. So, numerous Governing Council members, including hawks and doves alike and the most influential members of the Executive Board (i.e. Schnabel and Lane), have over recent weeks signalled their readiness to hike rates this month.

Inflation projections likely to validate current market pricing of rates with upside risks

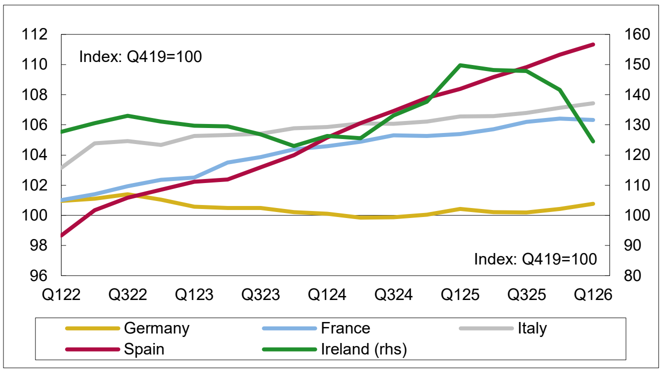
The case for the rate hike and forward guidance will be centred on the ECB's updated projections. As in March, we expect the Governing Council to receive three sets – a baseline projection predicated on recent wholesale energy forward prices as well as adverse and severe scenarios based on more downbeat assumptions for supply disruption at the Strait of Hormuz – and to refrain from attaching probabilities to them. We suspect that the updated scenarios will push back the assumed timetable for normalisation of supply volumes from Q326 and Q127 respectively in the adverse and severe scenarios. The longer that disruption is assumed to continue and oil prices are assumed to remain elevated, the greater will be the projected non-linear and second-round effects on inflation. And given the current stalemate in negotiations between the US and Iran, we expect the Governing Council to place more weight on the adverse and severe scenarios in their decision-making. The projections will be predicated on the path for policy rates recently priced by the swap markets, i.e. about 2.5 hikes by year-end, slightly more than in March. And given that the shock has become more persistent, we expect the near-term profile for inflation in all three scenarios to be upwardly revised. So, inflation in the baseline will be expected to remain above 3% this year, while the peak in the severe scenario could be revised up to 6.5%Y/Y or more. The shock will also be projected to weigh on activity for longer than previously assumed, although only the severe scenario will suggest two successive negative quarters of GDP growth. Most importantly for policy, not least as pay pressures remain limited and medium-term inflation

Euro area: GDP levels



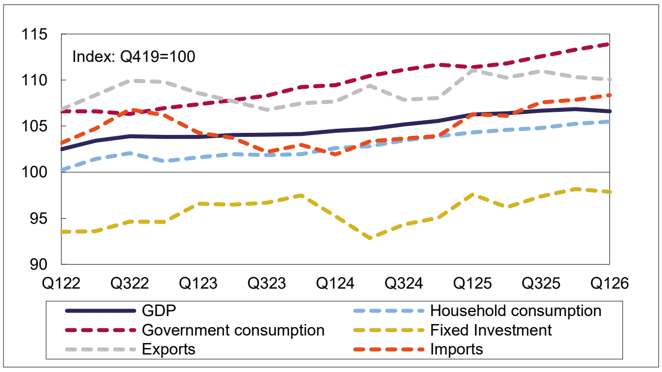
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area member states: GDP levels



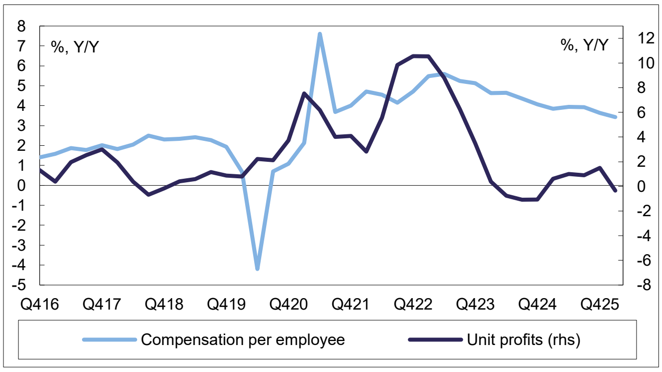
Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: GDP expenditure levels



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Unit profits & employee compensation



Source: Macrobond and Daiwa Capital Markets Europe Ltd.

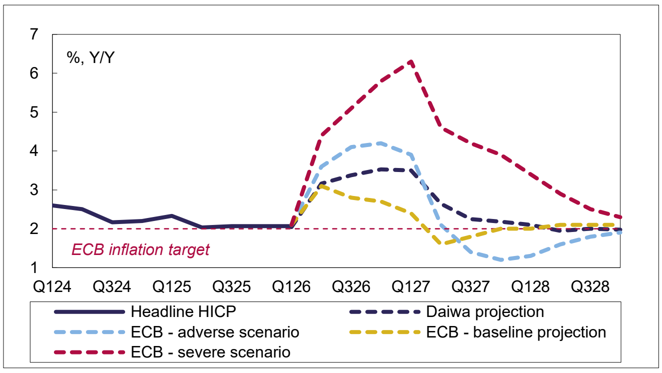
expectations remain relatively well-anchored, the baseline and adverse scenarios could well both continue to envisage the tightening priced by the market to suffice to return inflation close to target by the end of the projection period. That will reinforce our expectation that the ECB will hike twice this year unless we have the swift resumption of freight transit at the Strait. But under the severe scenario, inflation will be projected still to remain above target at end-2028 – perhaps at around 2.5%Y/Y – suggesting that additional tightening to that priced by the market might yet be required should the US-Iran stalemate persist well into the second half of the year.

The data week ahead in the euro area

Aside from the ECB announcement, it should be a relatively quiet week for economic data. Following on from today's underwhelming French IP figure (0.1%M/M), Germany's industrial output and goods trade data (both Tuesday) will shed yet more light on euro area activity at the start of Q2. Contrasting the improvement in exports, German production weighed on GDP at the start of the year. IP contracted a sizable 1.3%Q/Q, owing not least to the cumulative softness in pharma and a persistent drag from autos output. In fact, March's drop in manufacturing marked a fourth in succession, and took output to its lowest level since seasonal shutdowns dampened August's figure. The latest weakness also infers poorer odds of a rebound in Q2, but business surveys suggest that stockpiling and front-loaded production are likely to provide some near-term support. Moreover, based on the PPI data, cost pressures were still nascent in most sectors. And factory orders ended the quarter on a stronger footing too, up some 5%M/M. April's release (Monday) will provide some indication as to whether we can expect front-running efforts to provide greater support to manufacturing over the quarter as a whole. Alongside the German figures, IP data from Italy (Wednesday) will also contribute to broader predictions for April's euro area print.

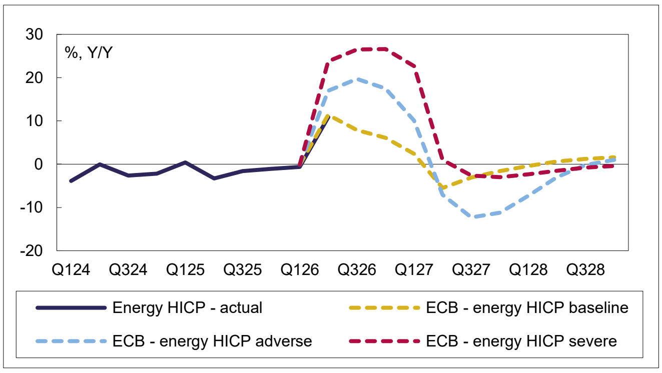
Thereafter, final inflation estimates from Germany, France and Spain (Friday) will provide insights into the drivers of the further increase in May's euro area figure. Although energy, somewhat unexpectedly, had a negligible effect on the preliminary euro area estimate, it is likely to have been central to the variation seen in each of the member states. Specifically, owing to the temporary tax cut on fuels, energy will explain most of the undershoot in Germany, where the flash HICP rate fell 0.2ppt to 2.7%Y/Y last month. But higher fuel inflation likely contributed to the further step-up in France. Still, given that the 0.2ppt increase in the headline rate for the euro area was driven by core components, and services in particular, the granular detail should be of most interest. We expect a fair amount of that pressure to have stemmed from an uptick in more volatile categories like package holidays and airfares, which had been subdued by seasonal distortions in recent months and are uniquely vulnerable to indirect effects associated with the oil shock. Otherwise, greater optimism about progress towards a resolution in the Middle East might translate into a slight improvement for this month's Sentix indicator (Monday), albeit showing that investor confidence remains heavily subdued compared to its pre-war level.

Euro area: ECB headline inflation projections



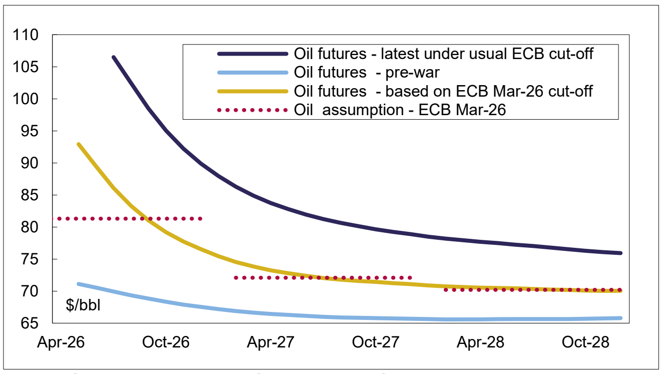
Source: ECB, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: ECB energy inflation projections



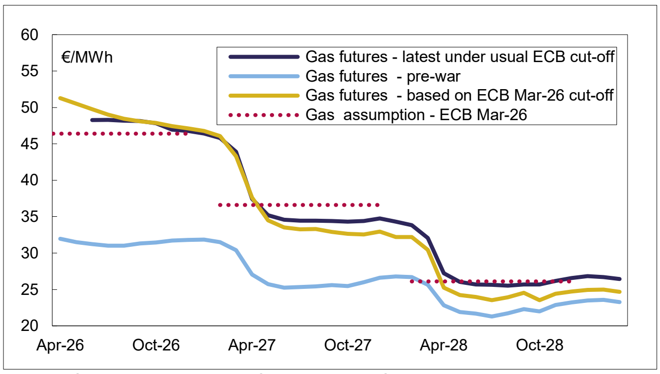
Source: ECB, Macrobond and Daiwa Capital Markets Europe Ltd.

Euro area: Oil futures curves & ECB assumption



Source: Bloomberg, ECB and Daiwa Capital Markets Europe Ltd.

Euro area: Gas futures curves & ECB assumption



Source: Bloomberg, ECB and Daiwa Capital Markets Europe Ltd.

Selected recent quotes from ECB policymakers*

ECB President Christine Lagarde (29 April)	"…we are certainly moving away from the baseline. Where to exactly... I'm not sure" "I think, directionally, I know where we're heading… But we shall see"
Isabel Schnabel (26 May)	"Prices are currently between the baseline and adverse [scenarios]. But [over longer horizons] the current oil futures curve stands above the adverse scenario…Given the size and the persistence of the current shock, looking through is no longer an option in my view. The shock is working its way through the economy and is shifting inflation away from our target over a significant period…From today's perspective, I think a rate hike in June will be needed"
Chief Economist Philip Lane (26 May)	"We are likely to make a further upward adjustment to the inflation forecast in June…The longer the conflict continues, the less likely the benign scenario…oil prices are likely to remain elevated for longer compared with our March assumptions."
Pierre Wunsch (3 June)	"[if there is no US-Iran deal, the decision in June] will be quite easy…[if we] set a very high bar for hiking, we may end up acting too late…I don't have very strong feelings [about further hikes]"
Olli Rehn (2 June)	"…while inflation risks have increased, a rate increase in June would be an insurance [hike], but not due to entrenched inflationary pressures. That assessment could change if the conflict becomes prolonged and if the transmission from energy prices to wages and broader inflation proves stronger than currently witnessed…"
Álvaro Pereira (31 May)	"I think it's better to act sooner rather than later so that we don't have much greater second-order effects later…"
Fabio Panetta (29 May)	"The forward-looking picture seems to call for a recalibration of the monetary policy stance to counter the risk of persistent inflationary tensions."
Gediminas Šimkus (29 May)	"…the scenarios that would lead me not to support a hike are unlikely…[short-term interest rates] are accommodative. A hike is needed to contain inflationary pressures and avoid second-round effects…I think a second hike is more likely than not, but I don't think we are now in a position to say whether it would be July, September or October."
Yannis Stournaras (27 May)	"The likeliest outcome is an interest rate hike in June…if there is an important but temporary overshoot of the inflation target, the response should be balanced"
Joachim Nagel (13 May)	"[4% inflation] cannot be ruled out. We are no longer in the [ECB's] baseline scenario, but moving in the direction of the adverse scenario…I still haven't given up hope that the situation in the Middle East will largely ease. But we cannot ignore the high energy prices. Interest rate hikes will become increasingly likely if the inflation picture does not change fundamentally."

**Light blue shading shows ECB Executive Board members and gold shading for Governing Council members.*
Sources: ECB, National central banks, Econostream, Bloomberg & Daiwa Capital Markets Europe Ltd.

UK

Elevated DMP price expectations likely to lead to a more hawkish balance of views on the MPC…

As we had already suspected given her previous comments, external MPC member Greene's call in her FT article yesterday for monetary policy to 'proactively lean' against potential second-round effects signalled that she – potentially with Lombardelli and/or Mann – is likely to join Chief Economist Pill in voting for additional restrictiveness at the June BoE policy meeting. Pill's position is even more hawkish than those of his fellow rate-setters as he takes a particularly dim view of the inflationary consequences of adverse structural shifts in the labour market. But the other hawks might share the judgement that a greater sensitivity to supply shocks has increased risks of second-round inflation effects. And in that regard, the BoE's DMP survey arguably provides some supporting evidence. As we had expected, the DMP's measure of output price expectations ticked up to 4%3M/Y in May, ½ppt higher than before the oil shock. And while they notably decelerated from 4%Y/Y back to 3.7%Y/Y, CPI inflation expectations at the 1Y-ahead horizon remained 75bps higher than the pre-war level. However, we would caveat that a significant share of the pressure in expected output prices reflected the leap in April, which appears to have been concentrated in the communications sector rather than broad-based. And medium-term inflation expectations remained relatively stable, barely 0.2ppt higher than in February, still consistent with levels seen late last year.

…but weak labour market & tighter financial conditions will keep the BoE on hold this month

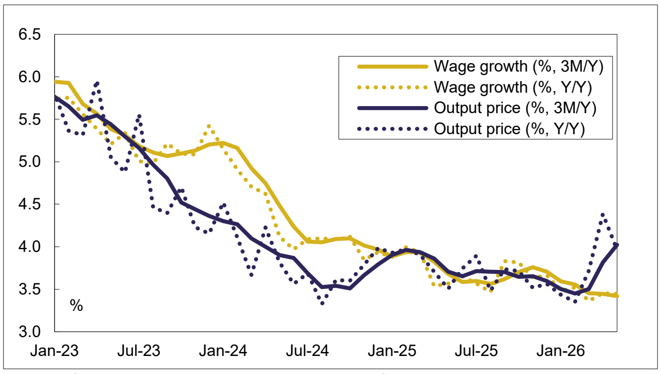
Of course, those caveats about price expectations offer little comfort that inflationary pressures won't materialise. And the evidence of higher output price intentions is likely to be indicative of increasing pass-through from energy to prices of other goods and services. But evidence of broader second-round effects via the labour market remains lacking. Indeed, with rising slack restricting worker bargaining power, wage expectations were unmoved in May and edged down to a four-year low (3.4%3M/Y) on a three-monthly basis. And as DMP respondents' employment expectations also slipped to the lowest level in six months, weak labour demand is likely to continue to keep a lid on wage growth over the coming months. So, as some MPC members including Greene have acknowledged, there appears significantly less likelihood that wages will serve as a channel for propagating broader inflationary pressures than in 2022 under much tighter labour market conditions and the significant post-pandemic imbalance between demand and supply. And with financial conditions already in restrictive territory, we assume that will keep a majority of MPC members from seeking to tighten before either certainty about events in the Middle East can be guaranteed or second-round effects become more evident.

The week ahead in the UK

April's monthly GDP report (Friday) will provide the best of the coming week's UK dataflow. That release surprised to the upside for a second consecutive month in March with growth of 0.3%M/M reinforcing a solid print of 0.6%Q/Q in Q1. Perhaps surprisingly, the onset of the oil shock provided a near-term boost to activity. And as those outturns imply a positive carryover into Q2, we see GDP expanding again this quarter. Moreover, the PMIs flagged a temporary acceleration in activity in April which might be indicative of further support to activity from frontloading efforts. But as the stagnation in the latest round of PMIs shows, the risks this quarter are skewed firmly to the downside. Moreover, several factors which offered support in March are also unlikely to have done so again in April. In particular, retail sales volumes fell back 1.3%M/M in April, after growth of 0.6%M/M, as households cut back spending on fuel after filling up at the start of the war. Core sales were also weaker, highlighting downside risks to consumer-facing services following the broader hit to confidence. The timing of Easter presents an additional source of uncertainty. In terms of manufacturing, support from normalisation in autos production related to last September's JLR shutdown appears largely exhausted. And the sharp pullback to the construction PMIs suggests that some payback for the strength of that sector in Q1 (1.5%Q/Q) might be forthcoming. So, overall, we expect monthly GDP to slip back at the start of Q2, by 0.2%M/M. That would leave GDP up 0.7%3M/3M, but we expect that momentum to slow to a more modest pace – potentially just 0.1%3M/3M – as Q2 progresses.

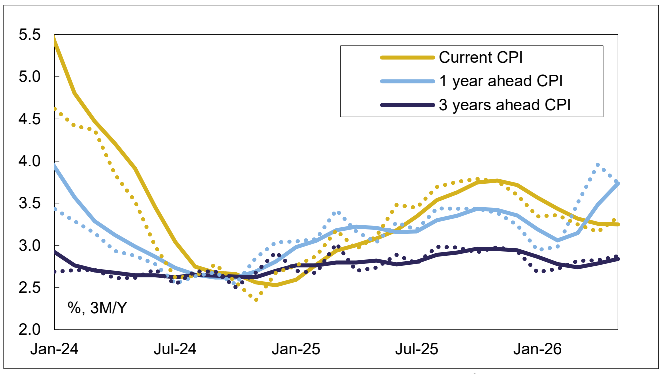
A handful of second-tier surveys are likely to reinforce that perception of weaker growth momentum over the coming months. Admittedly, the BRC retail monitor (Tuesday) should report an improvement in retail spending in May as Easter distortions – which saw like-for-like retail sales fall 6.5ppts to -3.4%Y/Y in April – disappear from the annual rate. But the underlying message is likely to be downbeat. And while a rush for completions might mean that housing market activity continued to offer temporary support to April's monthly GDP, May's RICS survey (Thursday) should continue to flag weaker activity in view of the recent sharp increase in mortgage rates. The REC's UK Report on Jobs (Monday) should also continue to highlight that labour demand remains weak. Otherwise, from a monetary policy perspective, the BoE's quarterly inflation attitudes survey (Friday) will be of interest. The previous iteration of the survey had reported a three-quarter low in households' year-ahead inflation expectations (3.2%Y/Y, down 0.3ppt). But that survey was conducted in mid-February, prior to the oil shock. So, an increase this quarter is inevitable. And the magnitude of the increase is likely to be of significance to the MPC's judgement about broader inflation risks, and potentially material for the more hawkish rate-setters in coming meetings.

UK: Firms' 1Y ahead expectations



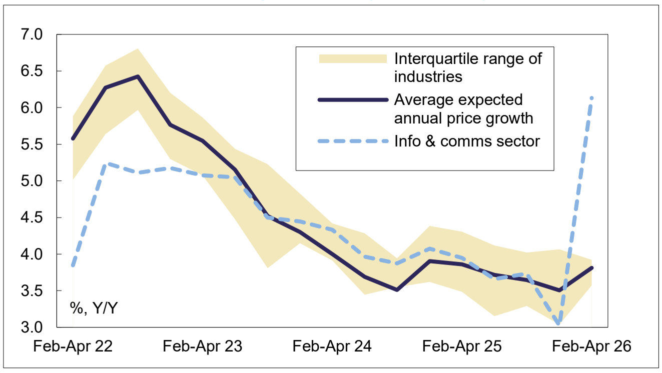
Source: BoE, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Firms' CPI inflation expectations*



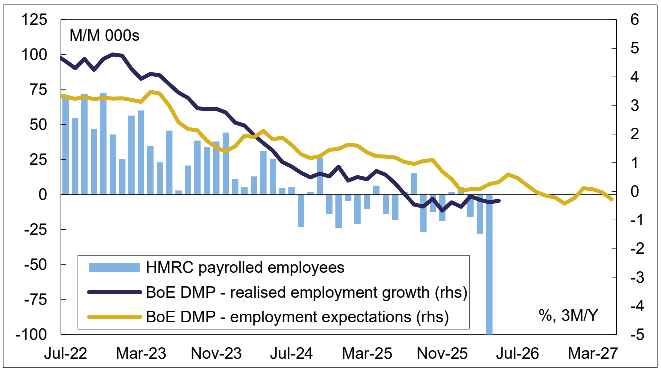
**Dotted lines show single-month (Y/Y) figures.*
Source: BoE, Macrobond and Daiwa Capital Markets Europe Ltd.

UK: Expected price growth by industry*



**Quarterly data to April 2026.*
Source: BoE DMP and Daiwa Capital Markets Europe Ltd.

UK: Payrolled employment & DMP indicators



Source: BoE, Macrobond and Daiwa Capital Markets Europe Ltd.

Daiwa economic forecast

	2025 Q4	2026 Q1	2026 Q2	2026 Q3	2026 Q4	2027 Q1	2026	2027	2028
GDP	%, Q/Q						%, Y/Y		
Euro area	0.2	-0.2	0.1	0.1	0.2	0.3	0.2	1.0	1.4
UK	0.2	0.6	0.1	0.0	0.2	0.4	1.0	1.1	1.4
Inflation, %, Y/Y									
Euro area									
Headline HICP	2.1	2.0	3.2	3.4	3.5	3.5	3.0	2.6	2.0
Core HICP	2.4	2.3	2.4	2.7	2.9	3.2	2.6	2.9	2.0
UK									
Headline CPI	3.4	3.1	2.9	3.6	3.7	3.6	3.3	2.9	1.9
Core CPI	3.3	3.2	2.6	2.9	3.2	3.3	3.0	3.2	2.3
Monetary policy, %									
ECB									
Deposit Rate	2.00	2.00	2.25	2.50	2.50	2.50	2.50	2.25	2.25
Refi Rate	2.15	2.15	2.40	2.65	2.65	2.65	2.65	2.40	2.40
BoE									
Bank Rate	3.75	3.75	3.75	4.00	4.00	4.00	4.00	3.50	3.50

Source: Bloomberg, ECB, BoE and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country	Release	Period	**Actual**	Market consensus/ *Daiwa forecast*	Previous	Revised
Euro area	GDP – final estimate Q/Q% (Y/Y%)	Q1	**-0.2 (0.3)**	*-0.2 (0.3)*	0.2 (1.2)	-
	GDP – household consumption Q/Q%	Q1	**0.2**	0.2	0.4	-
	GDP – government expenditure Q/Q%	Q1	**0.5**	0.5	0.5	0.6
	GDP – fixed investment Q/Q%	Q1	**-0.3**	0.2	0.7	0.8
	Employment – second estimate Q/Q% (Y/Y%)	Q1	**0.1 (0.5)**	*0.1 (0.5)*	0.2 (0.7)	-
France	Industrial production M/M% (Y/Y%)	Apr	**0.1 (2.8)**	-0.2 (1.8)	1.0 (0.9)	1.4 (1.3)
	Trade balance €bn	Apr	**-5.6**	-	-6.9	-6.4
UK	DMP – 3M output price (1Y CPI) expectations Y/Y%	May	**4.0 (3.7)**	*4.1 (4.0)*	3.8 (4.0)	-

Auctions

Country	Auction
- Nothing to report -	

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Daiwa Capital Markets

The coming week's data calendar

The coming week's key data releases

Country		BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
			Monday 8 June 2026			
Euro area		09.30	Sentix investor confidence indicator	Jun	-14.0	-16.4
Germany		07.00	Factory orders M/M% (Y/Y%)	Apr	-2.0 (4.3)	5.0 (6.3)
Spain		08.00	INE house price index Q/Q% (Y/Y%)	Q1	-	1.8 (12.9)
			Tuesday 9 June 2026			
Germany		07.00	Industrial production M/M% (Y/Y%)	Apr	0.3 (-1.2)	-0.7 (-2.8)
		07.00	Trade balance €bn	Apr	14.3	14.1
UK		00.01	BRC retail monitor – like-for-like sales Y/Y%	May	0.8	-3.4
			Wednesday 10 June 2026			
Italy		09.00	Industrial production M/M% (Y/Y%)	Apr	0.1 (0.5)	0.7 (1.5)
			Thursday 11 June 2026			
Euro area		13.15	ECB Deposit (Refinancing) Rate %	May	*2.25 (2.40)*	2.00 (2.15)
UK		00.01	RICS house price balance %	May	-31	-34
			Friday 12 June 2026			
Germany		07.00	Final HICP (CPI) Y/Y%	May	*2.7 (2.6)*	2.9 (2.9)
France		07.45	Final HICP (CPI) Y/Y%	May	*2.8 (2.4)*	2.5 (2.2)
Spain		08.00	Final HICP (CPI) Y/Y%	May	*3.6 (3.2)*	3.5 (3.2)
UK		07.00	Monthly GDP M/M% (3M/3M%)	Apr	*-0.2 (0.7)*	0.3 (0.5)
		07.00	Services output M/M% (3M/3M%)	Apr	-0.2 (0.8)	0.3 (0.8)
		07.00	Industrial output M/M% (Y/Y%)	Apr	0.1 (-0.1)	-0.2 (0.0)
		07.00	Construction output M/M% (Y/Y%)	Apr	-0.6 (-1.7)	1.5 (-0.3)
		07.00	Trade (goods trade) balance £bn	May	-5.4 (-22.9)	-9.7 (-27.2)
		09.30	BoE/Ipsos inflation attitudes survey – 1Y ahead CPI Y/Y%	Q2	-	3.2

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

The coming week's key events & auctions

Country		BST	Event / Auction
			Monday 8 June 2026
UK		00.01	REC, KPMG and S&P Global UK Report on Jobs for May
			Tuesday 9 June 2026
Germany		10.30	Auction: to sell up to €500mn of 2.3% 2033 green bonds
		10.30	Auction: to sell up to €500mn of 2.5% 2035 green bonds
		10.30	Auction: to sell up to €1bn of 1.8% 2053 green bonds
			Wednesday 10 June 2026
Germany		10.30	Auction: to sell up to €5bn of 2.9% 2036 bonds
			Thursday 11 June 2026
Euro area		13.15	ECB monetary policy announcement
		13.45	ECB President Lagarde holds post-Governing Council meeting press conference
		13.15	ECB to publish updated Eurosystem staff macroeconomic projections
Italy		10.00	Auction: to sell bonds*
UK		10.00	Auction: to sell £5bn of 4% 2029 bonds
			Friday 12 June 2026
Germany		-	Bundesbank to publish updated economic forecasts for Germany

**Details to be announced. Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*